PHILIP MORRIS
EUROPE MIDDLE EAST AFRICA
BELLANCOURT 1006 LAUSANNE

# INTER-OFFICE CORRESPONDENCE

To: Mr. E. Houminer

From: W.T. Martin

Subject: C A R T I E R

Date: January 27, 1982

C.C.:

The following comments summarize our analysis of the Cartier business, mainly from data supplied by the company but also drawing on impressions gained from the attached translation of an article in the German "Manager Magazin". The general conclusion is that this is not the type of business in which PM should become involved. The reasons for this are given at the end of the memo and should provide G. Weissman with sufficient arguments in any discussions with Dr. A. Rupert.

Two factors have not been addressed below and can only be guessed at: why are the current owners willing to sell ? Why is Dr. Rupert attracted to the business ? In answer to the first question, it may be that profits are now at a zenith, further progress requiring further diversification, with greater risks that the profit performance cannot be continued. This may also be part answer to the second question, in that perhaps Dr. Rupert does not fully understand the current status of the business but the idea attracts him.

It is also worth noting that Rembrandt has rights to the Cartier trademark, for cigarettes, until at least 2005. Therefore, an investment would not appear warranted to protect the trademark rights.

## Structure

Following a re-organization in August 1979, Cartier Monde, Luxembourg, became the main holding company for the world-wide Cartier entities, previously held by different shareholder groups (see attached chart). Cartier Monde owns, directly or indirectly and with minor exceptions, the world-wide rights to the use of the Cartier name and trademarks.

The Managing Director of Cartier Monde is Mr. Joseph Kanoui, previously a consultant of the company and a friend of Mr. Hocq, the former Managing Director now deceased, and very respected by Dr. A. Rupert. The Board of Directors comprises Kanoui, Nathalie Hocq (the daughter of the former Managing Director), N. Perrin (Marketing Director), and representatives of the other shareholders.

The major shareholders are the Leista Foundation 67% (Hocq 60%, Rupert 40%), PARIBAS 19% (66% thought to be held on the bank's own account), 3% held by a Manager minority (Kanoui, Perrin ?); various minor shareholdings making up the balance. Dr. Rupert's interests are believed to have started in 1972, and he reportedly paid $ 8.0 mio. for them.

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Source: https://www.industrydocuments.ucsf.edu/docs/mhlm0000

The corporate structure or organization is complicated to the extent that it has been constructed in a manner to minimize taxes. There is reinvoicing through a Swiss company for much of the international business, a Curacao company figures high up in the chart, and a duty-free depot exists in Switzerland. Cartier's effective tax rate was only 13.7% for 1980.

Activities

The company is organized into two divisions, Distribution (71% of 1980 sales of $ 224 million, plus another 6% internal sales at transfer price to Jewellery division) and Jewellery.

The Distribution division manufactures and wholesales "Les Must de Cartier" luxury products, and controls its own subsidiaries in the most important markets world-wide (third-party agents are used in territories where turnover is not material). The breakdown of sales value (actual 1980 versus budget 1982) is shown below, indicating that Cartier is essentially a watch company:

| | 1980 A | 1982 B |
|---|---|---|
| Watches | 55% | 58% |
| Lighters | 10% | 8% |
| Pens | 5% | 4% |
| Leather Goods | 12% | 11% |
| Jewellery | 8% | 7% |
| Perfume | - | 6% |
| Other | 10% | 6% |
| | 100% | 100% |

These products are designed and developed by the group and manufactured either by the group (mainly lighters by Usiflamme in Switzerland) or manufactured by sub-contractors in various countries (Switzerland, Italy, Spain, France, Brazil and USA).

Distribution division activities range from production through international and national wholesaling to retailing. The division also has a large network of franchisees (67) operating retail boutiques under the "Les Must de Cartier" name and selling the whole product range. Other retailers are licensed to sell part of the product range (with the exception of jewellery) and number around 5000.

The Jewellery division consists mainly of the retailing of luxury products through a limited number of outlets in Europe and the United States, ie. London, Paris and New York. The product range includes both high-range products created in the division's own workshops, and also medium-range jewellery some of which is made by subcontractors. Also included are the "Les Must de Cartier" products supplied by the Distribution division (which account for approximately 30% of the sales value of Jewellery division to external customers).

There are 1200 people employed world-wide (two-thirds Distribution, one-third Jewellery). At least the top management is considered of high-quality, and is very well compensated.

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Financial Performance

The Profit and Loss development in recent years, translated at actual exchange rates, is as follows:

| $ M | 1978 | 1979 | 1980 | 1981 | 1982 |
|---|---|---|---|---|---|
| Sales | $ 141 | $ 182 | $ 224 | $ 233 | $ 276 |
| Distribution Divn. | NA | NA | $ 173 | $ 178 | $ 218 |
| Pre-Tax Profit | $ 19 | $ 27 | $ 30 | $ 25 | $ 37 |
| After-Tax Profit | $ 15 | $ 20 | $ 26 | - | - |
| Effective Tax Rate | 24.3% | 24.9% | 13.7% | - | - |

(NB. the 1978 and 1979 figures are unaudited pro-forma data to give comparative information following the restructuring of the group).

The effective tax-rate reflects the corporate structure conceived for this purpose; PM would pay a rate nearer 46%. Further, Cartier has obtained tax holidays from the Canton of Fribourg, which reportedly expired in 1981.

The balance sheet summary is as follows (1978 on pro-forma basis to reflect restructuring of the group):

| | 1978 $ M | 1979 $ M | 1980 $ M |
|---|---|---|---|
| Inventories | 43 | 57 | 76 |
| Receivables | 54 | 47 | 60 |
| Gold | | - | 16 |
| Cash | - | 14 | 7 |
| | 97 | 118 | 159 |
| Current Liabilities | (65) | (66) | (94) |
| Fixed Assets | 14 | 18 | 23 |
| | 46 | 70 | 88 |
| Shareholders Funds | 39 | 58 | 76 |
| Long Term Debt | 6 | 8 | 8 |
| Deferred Tax | 1 | 4 | 4 |
| | 46 | 70 | 88 |

Based on the reported asking price of 10 times "average" earnings of $ 24 million, 1980 shareholders' equity and a 50% participation (also ignoring any possible write-up of fixed assets and inventories), PM might incur a goodwill element of $ 82 million, written-off annually at $ 2 million gross and net of tax over 40 years.

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The breakdown of sales by product of the Distribution division was shown above. The geographic/affiliate breakdown of these sales is as follows:

| | 1980 A | 1982 B |
|---|---|---|
| France | 21.2% | 17.1% |
| Italy | 9.6% | 7.8% |
| Switzerland | 6.5% | 5.5% |
| Germany | 5.6% | 5.1% |
| Other Europe | 7.9% | 10.5% |
| Europe | 50.8% | 46.0% |
| U.S.A. | 12.4% | 12.3% |
| Hong Kong | 14.9% | 17.2% |
| Other | 1.7% | 5.0% |
| International Distribution | 20.2% | 19.5% |
| | 100% | 100% |

"International Distribution" are sales invoiced primarily in Swiss Francs to countries where no Cartier affiliates exist, as well as duty-free business. A breakdown of these by geographic area is available for 1982 B:

| | 1982 B |
|---|---|
| Japan | 4.1% |
| F. East | 5.8% |
| Europe | 2.6% |
| Americas | 6.5% |
| Other | 0.5% |
| | 19.5% |

In terms of relative weight of currencies contributing to consolidated turnover, the order is the French Franc, the US dollar and the Swiss Franc.

Future Prospects

Cartier's past success has been impressive but has been based primarily on extending the "basic" products (ie. watches, lighters and leather goods) into wider geographical distribution. The market for such exclusive and prestigious items must, by its very nature, be limited, or the image of the product will suffer. Therefore, the company has increased its product range to cover around 500 different articles, with the risk of endangering the quality image of the trademark.

Pens have not really been successful to date. The Jewellery division markets a large number of different items, but its net profit as a percentage of sales is only half that of the Distribution division. The recent launch of a perfume range was made at very high cost, and the success of this cannot be gauged at present. The group also launched a crystal and silver collection "Arts de la Table" in 1981 and a line of spectacles (à la Christian Dior) is planned for 1982.

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Such activity suggests that Cartier is striving hard to maintain past performance by extending its range of products, which has potential problems: firstly, there is the risk of expensive failure inherent in any new product launch; secondly the danger that an overconcentration on product, rather than image, will be to the overall detriment of the company's long-term interests.

There are also signs that the strict pricing policy which Cartier attempts to impose is coming under attack. The famous British store, Harrods for example, was offering a 25% discount on "Les Must de Cartier" in the Summer of 1981, and there is evidence of this having happened elsewhere such as in West Germany and Hong Kong. This suggests that Cartier is encountering increasing difficulty in it's co-operation from the trade on an international basis. The result may be that the target group no longer corresponds to the actual circle of customers, which will not help the overall image of the trademark (see attached article).

Conclusions

PM's reluctance to participate in an acquisition of Cartier can be based on a number of arguments which Dr. Rupert should recognize and understand:

Fiscal constraints on US corporations are possibly incompatible with the philosophy of Cartier and would also mean lower profits -

- PM would face a far higher tax charge (46%) than the effective rate paid by Cartier (14% to 25% in recent years). Our valuation of what is a "net profit" is different to Cartier's or Rupert's.

- The need for full disclosure to the IRS by PM (including 959 forms for all Cartier subsidiaries) could have repercussions on the corporate structure, perhaps requiring restructuring which may be against the interests of a partner.

- PM is unable to effect any tax charge against goodwill created by the transaction, reducing the effective return of the investment, and possibly affecting profits by $ 2.0 mio. per annum.

PM cannot bring expertise or management strength to the business and would be unwilling to be a passive investor -

- The current management of Cartier is considered good and, even were PM able to offer people resources, this would appear to be superfluous.

- PM's management philosophy is not consistent with that required to run retail businesses selling fashion-based multiple product lines.

- PM's management resources are fully employed in its fast growing cigarette businesses, particularly since the association with RI.

Further, there is the possibility that profits are at a zenith and further rapid development is questionable; an investment in Cartier is not necessary to secure the cigarette trademark rights.

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This argument could be supported by the overall world economic situation and the lesser disposable income available for luxury goods. Also, Cartier's rush to extend its product line and geographical distribution have apparently lessened the marketing attraction of the trademark and its exclusivity.

W.T. Martin

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